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Contents

FOREWORD

For many years AIER has held the view that economists tend to construct economic models of various stripes that, no matter how ingenious or emotionally appealing, often ignore the observed characteristics of human behavior. This tendency has been especially pronounced in monetary economics, where numerous theoretical models have been used to promote policy prescriptions for refining the management of monetary policy through discretionary controls. In the past, they have spawned a wide array of divergent proposals — price rules, interest-rate rules, "target zones" for the monetary aggregates, and the like. Monetary authorities have adopted such mechanisms from time to time even though there may have been little understanding (evidenced by continuing debate among the "experts") of the actual relationship between the proposed indicators and underlying money supply-demand conditions.

Even if unanimous agreement on some policy were possible, it would serve no useful purpose if such discretionary controls are virtually certain to be abused by the monetary authorities. Many years ago, E. C. Harwood, who founded both AIER and Progress Foundation, insisted that the prospects for developing solutions to monetary problems (and other human problems) would remain dim so long as economists and other behavioral scientists clung to procedures of inquiry that encouraged analysis of "separate parts" of a problem in isolation from other pertinent factors. Analysis of the monetary question, which first and foremost would seem to require consideration of the political and other "exogenous" elements involved, is a case in point. More than 25 years ago, Col. Harwood suggested that many perceived monetary problems would not be resolved by applying conventional economic analysis, and that fundamental "constitutional" changes probably would be required if there were to be a return to a sound money and credit system.

The conference proceedings that appear on the pages that follow are generally in accord with and develop this view. While they disagree on some matters respecting the structure of an alternative "monetary constitution," Professors Bernholz and Buchanan, both eminent authorities and one a Nobel laureate, agree on a number of key points: that discretionary monetary regimes have an inherent inflationary bias; that the current monetary regime is the worst imaginable; that "quick fixes," say, a return to a fixed exchange rate system, will not solve the problem; and that fundamental constitutional change is needed to remove all political considerations from the money system. As their concluding discussion suggests, short of a return to a genuine gold coin standard, which in Professor Bernholz's view would most effectively restore a sound money regime, prospects for useful change might in the meantime be

enhanced by a constitutional provision allowing private parties to denominate debt in whatever unit of account they may choose.

Explicit in both of their presentations is the notion that, if useful alternatives are developed through sound research now, then at some point in the future "when the time is right politically," useful corrections might be introduced prior to a monetary catastrophe. It might be noted that this view diverges markedly from most conventional work in monetary economics, which either ignores the matter of implementation, or else implicitly assumes that the hypothetical regime is "automatically" fully operative. It also diverges from much (but not all) of prior experience. The type of constitutional reform discussed here usually has not evolved gradually, but rather has been introduced very rapidly out of desperation in "panic" situations after an existing monetary regime has effectively collapsed — with vast disturbance to all.

As Professor Buchanan observes, in actual situations, and regardless of whatever change eventually does or does not occur, many obstacles block the path to genuine constitutional reform of any sort. But greater interest in such change is being shown than previously, as it has in other times and places when existing money arrangements began to fail. The process he describes necessarily is slow, and provides no guaranteed results. However, the alternative is even more dismaying: continuing chaos under the current regime, in all likelihood culminating in the type of catastrophe described above.

Whatever transpires, it may give some hope to know that scholars of the caliber of Professors Bernholz and Buchanan are now working on such problems within the academic "establishment," and that serious attention is being given to their work. Their discussion of ***Prospects for a Monetary Constitution*** is a particularly welcome, and timely, addition to Progress Foundation's biennial international monetary conference series, which AIER is privileged to organize.

Conference Schedule

Conference convenes

Dr. Marcel Studer, Chairman, Progress Foundation

Welcome by Dr. Claudio Generali, Director of Finance and President, Canton of Ticino

Introductory remarks by Dr. Rollo Handy, President, American Institute for Economic Research

Conference agenda, Dr. Robert Gilmour, Director of Research and Education, American Institute for Economic Research

"Prospects for a Monetary Constitution"

Professors Buchanan and Bernholz

Audience Participation

Moderator: Dr. Gilmour

Conclusion and adjournment by Dr. Studer

Proceedings of the Conference

Dr. Marcel Studer, Chairman, Progress Foundation:

Ladies and gentlemen, on behalf of Progress Foundation, I welcome you heartily to our 1988 international monetary conference. I am pleased to welcome in particular Dr. Claudio Generali, member of the Government of the Canton Ticino and Head of its Department of Finance; representatives of the Swiss universities, among others Professor Dr. Nydegger from the Hochschule St. Gallen; the many prominent members of the banking community of the Canton Ticino, among them Mr. Hans Hartung, former member of the Federal Banking Commission; and, last but not least, our friends from the press.

Progress Foundation has as its objective "the support of research into those aspects of human behavior, including social organizations, that either foster the advance of civilization or help to account for the decline of civilization." This may seem to be an open-ended playground for *l'art pour l'art* scientists of undefinable shade. Progress Foundation, however, in conformity with its founder Col. Edward C. Harwood, focused its activities from the beginning on a very practical aspect: on the effect of national or political economy, and, more specifically, of its monetary aspect, on our civilization. This is why our first monetary conference, held 4 years ago in this same room, was dedicated to the subject "Money: A Search for Common Ground."

The topic of today's conference is "Prospects for a Monetary

Constitution," and we are proud that two most-distinguished representatives of economic science accepted our invitation to be our guest speakers. Dr. Peter Bernholz, Professor at the University of Basle and Director of the Institut für Volkswirtschaft in Basle, and Dr. James M. Buchanan, Harris University Professor at George Mason University and Director of the Center for Study of Public Choice, 1986 Nobel Prize laureate and Honorary Doctor of the University of Zurich. I am sure you will follow their lectures with interest.

The Board of Trustees asked me to inform you of its recent decision to award a Progress Foundation book prize every 2 years for an outstanding publication in economics. This prize will be presented on the occasion of our monetary conferences, for the first time therefore in 1990. Now, ladies and gentlemen, I am pleased to ask Dr. Claudio Generali to speak.

Dr. Claudio Generali, Director of Finance and President of the Canton Ticino:

Mr. Chairman, ladies and gentlemen, I am pleased and honored to welcome the Progress Foundation to the Ticino, which is the second time in a few years that I have had the pleasure of addressing its monetary conference on behalf of the government. I think this sort of conference, which is not a usual occurrence here in Lugano, especially with the presence of a Nobel laureate, is very important for this community, the financial community in the Ticino, and for the financial reputation of Ticino. I am thankful to Progress Foundation for pursuing the initiative in making this conference possible.

What has a member (at the moment, the President) of the government of the Canton Ticino, a small entity as you well know, to tell to an audience like this? As a nonpracticing economist, I would have a lot of subjects, a lot of questions, to pose to such distinguished guests. As a repenting Keynesian, I would ask how much of the monetarist approach do we need and how much of the traditional way of organizing a budget and making ends meet do we choose in order to rule even such a small entity as a canton in Switzerland? As a practicing politician — and I say that with no shame — I would then have another question to ask: namely, what is in the future? Are the fiscal and monetary policies that are practiced today in the Western world the right mix, the right way, to approach the problems?

But, in a welcoming address, there is no time to ask these sorts of questions. So, I must get to the conclusion. I very much thank Progress Foundation for organizing this conference, and I thank you all for your attention.

Dr. Rollo L. Handy, President of American Institute for Economic Research:

Dr. Studer, Dr. Generali, ladies and gentlemen, I shall say just a very few words about the connection between Progress Foundation and the American Institute for Economic Research in Massachusetts. Both organizations were founded by the late E. C. Harwood and both, as Dr. Studer mentioned, are very interested in economics. To many people, economics still is defined as the "dismal science" and I suspect that even some of the students of Professors Buchanan and Bernholz feel that way from time to time. When, many, many years ago, I first came to Lugano, I was impressed that Col. Harwood had chosen the Ticino as the seat of Progress Foundation, because it seemed to me where better could one practice the dismal science than in the beautiful Ticino?

So, AIER is very pleased to be able to cooperate with Progress Foundation in arranging these conferences, and, as President of AIER, I have taken the very firm view that we should do anything Progress Foundation wants. We have only one nonnegotiable demand: the conferences always must be held on the shores of Lago di Lugano.

Dr. Gilmour, who is Director of Research and Education at AIER, will be the moderator for the serious part of the conference.

Dr. Robert A. Gilmour, Director of Research and Education, American Institute for Economic Research (editorial note):

For purposes of publication, these conference proceedings have been divided into several sections that differ somewhat from the organization of the conference program. Professors Buchanan and Bernholz prepared formal papers for the conference, which are published here in their entirety. In the conference itself, however, they delivered orally only summaries of their arguments. Professor Buchanan began the conference with general comments; then Professor Bernholz gave a lengthy presentation of his data; and then Professor Buchanan returned to the podium. The oral presentations omitted some material in the written papers, but included other pertinent remarks and observations that were not included in the papers.

In order to capture all pertinent proceedings, any material presented orally and not duplicated in the papers has been included here. The presentations appear in the following order: 1) the formal conference papers; 2) Professor Buchanan's comments following the initial oral presentations; 3) addenda to the written papers, which include any remarks made orally that did not appear in those papers; 4) a transcription of questions and answers given during the audience participation period.

It is perhaps appropriate to note at this point that many published conference proceedings are highly "sanitized" before they are committed to printed page (and may, for the sake of neatness, omit even highly pertinent material if it interrupts the "flow" of an argument). In our view, such practice may inadvertently distort the ways that "scientific" discussion often proceeds — and may give published research findings, conjectures, and such an appearance of certitude that is unwarranted. To avoid such distortion, we have endeavored here to be as faithful to the actual record as possible. Of course, some minor editing has been necessary. But wherever possible, we have retained the language of the participants in hopes that even some "gaffs" may be instructive about the (necessarily imperfect) ways in the which research discussions develop.

PROLEGOMENA FOR A STRATEGY OF CONSTITUTIONAL REVOLUTION

by
James M. Buchanan

I. Introduction

When I was invited to present this lecture, it was suggested that I use the occasion to follow up and to develop my comments and discussion of the paper presented by Professor Peter Bernholz at a Washington, D.C. conference in 1986. Bernholz's paper was on prospects for reform in monetary constitutions, and my comments were entitled, "The Relevance of Constitutional Strategy."[1] I shall try to respond positively to the suggestion by examining prospects for genuine constitutional reform in the late 1980's and early 1990's. Is the time at hand when genuine constitutional revolution in Western countries may be possible? How could we recognize the elements of the socio-economic-political interaction process, including the attitudes of the participants, that might bring constitutional reform within the realm of the feasible? Can we identify steps that the political economist might take to direct or to channel discussion toward mutually beneficial changes in the rules of the political game?

In the paper mentioned, Bernholz limited his attention to prospects for change in monetary regimes, and he introduced a discussion of how separate interest groups might converge in support of regime change during specifically identifiable phases or stages of cycle described by differential rates of inflation. That is to say, the Bernholz argument suggested that the prospects for constitutional reform may vary with the situational setting and that an examination of the convergence and/or divergence among the separate interest groups may generate, for the observing political economist, a basis for a constitutional strategy. I propose here to go even further back in analysis, so to speak, and to examine the basic features of the "dilemma" that exists, pre-reform, in each of three "constitutions," the regulatory, the fiscal, and the monetary. Once these elemental features or characteristics have been identified, the problems faced in any reform strategy are more readily subject to analysis.

It will first be necessary to define, very briefly, what I mean by constitutional change, reform, or revolution. I shall, of course, be covering material here that I have discussed in many earlier books and

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[1] Peter Bernholz "The Implementation and Maintenance of a Monetary Constitution," *Cato Journal*, 6 (Fall, 1986), 477-512; James Buchanan, "The Relevance of Constitutional Strategy," *Cato Journal*, 6 (Summer, 1986), 513-518.

articles. But a short summary, presented in Section II, seems essential in order to insure that my subsequent argument is understood.

After the summary statement of the constitutional perspective, I shall, in Sections III, IV, and V, examine the distinct features in the separate diagnoses of the regulatory, the fiscal, and the monetary constitutions.

II. The Economy as a Constitutional Order

Those who conceptualize national economies as networks of macro-aggregates that can be managed or manipulated for the purpose of promoting the achievement of macroeconomic objectives cannot understand what the terms "constitutional reform" or "constitutional revolution" mean. In this conceptualization, economic policy is straightforwardly teleological; there exist objectives worthy of achievement that are recognized by the authorities, and the economy must be guided towards such ends.

The constitutionalist perspective differs dramatically in its fundamental conceptualization of what the "economy" is. Here the political economy is conceived as a *constitutional order* that, in itself, and, as such, embodies no independently defined objective or goal, and has no function. The order is best described as a set of rules, or constraints, within which individuals, and organizations of individuals, interact, one with another, in promoting their own, individually initiated, purposes. Patterns of outcomes or results (allocations, distributions, utilization and growth rates) depend critically on the rules that constrain both private and public choices. And persons, generally, may judge some patterns of outcomes to be less desirable than others that might be generated under alternative rules. In such circumstances, there may be general agreement on a change in the rules, or constitutional reform.

It is essential to recognize that the choice of a rule (or a set of rules) within which a pattern of outcomes may emerge over a sequence of interactions, is categorically distinct from the choice of an outcome or result that has well-defined characteristics. Policy is misdirected to the extent that it is motivated by the notion that specific outcome targets can be achieved. Even an ideally omniscient and benevolent authority could not choose an allocation of resources, a distribution of income, a rate of resource utilization, or a rate of economic growth. This proposition holds even if we totally ignore issues relating to the definition of what the ideals would look like in each case.

The social interaction process necessarily involves choices made by the many separate individuals and organizations in the economy-polity, each one of whom chooses subject to the constraints that are separately confronted. The many choices generate one outcome from among a whole set of outcomes that might emerge within the same set of con-

straining rules. To model policy as if the alternatives for "social choice" are outcomes amounts to a denial that participants retain independent powers of choice. Those who choose rules for games do not, in doing so, choose solutions; rather, solutions *emerge* from choices of players made within the rules that constrain them.

Regardless of the ultimate location of political authority, whether this be concentrated in a single person, party, or class or dispersed among many persons who act through some collective decision making institutions, any imposed politically directed action, and law, must modify the constraints for all those who choose in any of the many capacities or roles. In this narrowly defined sense, any political action must be "constitutional." It seems preferable, however, to restrict the usage of the term "constitutional" to those actions that have rules changes as their primary purpose.[2] The "economy as a constitutional order" is described by the set of rules within which individuals and organizations (including government) make choices and implement them in subsequent actions.

An existing constitution is evaluated through reference to the relative desirability of the pattern of outcomes that it allows the choices of participants to generate stochastically over a temporal sequence. The problems that arise in diagnosing "constitutional failure" are difficult and not well understood, even if we restrict attention to evaluation by a single person, whether this person be an active participant or an outside observer. My concern here is not, however, with such problems, as difficult as these may be.[3] My concern is with the comparative evaluation of an existing set of rules made by the many separate persons in a constitutional democracy, where basic changes in structure are made, ideally, only upon consensual agreement.

It is, first of all, self-evident that any agreement on diagnosis of a constitutional order is enormously more difficult to achieve than the making of a diagnosis itself by a single person, or even by a group of persons who share evaluative norms. In particular, if the *status quo* set of rules, or some part thereof, is consensually diagnosed as needing reform or change, players must not only agree that the "game" played out within

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[2] Taxation offers an example. Any tax will modify the constraints faced by individuals in the polity, even the lumpsum tax that is often used for bench-mark comparisons by public finance theorists. But a tax levied for the purpose of financing public outlay, which will change constraints for individual choice, is not exclusively aimed at accomplishing the behavioral change induced by the modification of constraints. In the terminology suggested here, only the latter tax is to be considered "constitutional."

[3] See, Rutledge Vining, *On Appraising the Performance of an Economic System* (Cambridge: Cambridge University Press, 1984), for a concentrated treatment of some of the issues in constitutional diagnoses at the level of the individual evaluator.

the existing rules is negative sum, in some appropriately defined opportunity cost sense, but, also, there must be agreement upon the alternative set of rules that is predicted to yield higher utility levels. The monetary regime offers a good example. There may be general agreement that an existing regime "fails" in comparison with some alternative regime, but agreement may break down on identification of the alternative with which the existing regime is compared. The discretionary authority of national central banks may be judged to be nonpreferred, by all parties, but the preferred alternative may be a gold standard by some and a rule-directed fiat system by another.

Is it not absurd to think that the required consensus could ever be attained? Will not there be at least some major groups in a polity that will consider any existing rules preferred over any alternative? I do not underestimate the magnitude of the challenge here. But, by way of precaution, we must keep in mind that, if there is no agreement possible on any change, then the existing set of rules is, in this sense, to be considered optimal. The simple logic of Pareto criteria tells us that if an existing state of affairs is to be evaluated as Pareto-inferior, there must exist at least one alternative that is Pareto-superior. The challenge to the political economist is to locate the set of changes that will command general agreement.[4]

III. Features of the Regulatory Dilemma

I propose to examine, in turn, three areas where constitutional failure seems to be present in Western democratic nations, three "constitutions." I shall try to outline, in each case, elementary features of the pre-reform setting. This step is required *before* any discussion-analysis of possible change in rules.

In this Section, I consider the general area of "regulation," by which I refer to the direct intrusion of politicized controls over market interaction. The familiar examples are political controls over (or interferences with) terms of potential voluntary exchanges of goods and services: controls over wages, prices, interest rates, rents, entry into and exit from occupations, industries, and locations. In each case, the political controls are motivated by producer group interests, which seek to secure benefits (monopoly rents) at the expense of the citizenry generally. Any change in rules that prohibits such political control is clearly not to the particularized interest of any such potentially favored group if the policy issue

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[4] For a statement of this general methodological position, see, my "Positive Economics, Welfare Economics and Political Economy," in my *Fiscal Theory and Political Economy* (Chapel Hill: University of North Carolina Press, 1960), pp. 105-124. Also, see, W. H. Hutt, *A Plan for Reconstruction* (London: Kegan Paul, Trench, Trubner, 1943).

affecting that group is taken one at a time and in isolation. The potential or actual beneficiary group or class will never freely assent to piecemeal constitutional change. The particular interest of the group will be damaged in the process.

By contrast, each group that finds itself damaged by regulations that serve to generate particularized benefits to other groups and interests would, in its *constitutional* interest, prefer that all of the other regulations be removed and that exchanges be allowed unrestricted domain over these sectors of economic life. If this generalized conflict between the individual's particular interest and his constitutional interest is acknowledged, then the way seems open for a general agreement that will prohibit, constitutionally, any political interference with the freedom of voluntary exchange. If the number of producer groups that secures political protection becomes sufficiently large, the losses suffered, even by a protected producer group, may outweigh any gains from the protection. In this setting, the members of all protected producing groups, along with nonproducers in the economy, will agree on a change in rules that eliminates protection over *all* groups.

The essential feature of this pre-reform regulatory setting is described in the classical prisoners' dilemma. Given the constitutional rules of the game, as they exist, producer groups maximize utility by seeking protection under the state's regulatory umbrella. As more and more groups succeed in this effort, a point is reached where members, even of those groups that are protected by regulation, are worse off than they would have been or would be in the absence of political regulation generally. But the generalization feature is worthy of emphasis here; it would not be in the utility-maximizing interest of any protected group to seek removal from the protective umbrella of regulation in isolation from the other protected groups. Constitutional reform can only be successful if it is sufficiently *general* to bring in large numbers of separate producer interests and remove all of these, simultaneously, from the regulatory umbrella.

IV. The Potential for Reform in the Fiscal Constitution

The central flaw in existing fiscal constitutions lies in the absence of any constraint on the debt financing of current public consumption. The effect of the Keynesian revolution in economic policy was to repeal effectively the balanced budget norm for fiscal prudence. Post-Keynes, political decision makers have felt free to exercise their natural proclivities to spend without taxing currently, proclivities that are based on the desires to meet demands of constituents. As I have argued on numerous occasions and in many forums for three decades, the suggested constitutional reform is simple and straightforward and represents the implemen-

tation of a central principle of classical public debt theory. The constitution should be changed to include a prohibition of debt financing of outlay on currently consumed publicly provided goods, services, and transfers.

Note, however, that the basic features of the pre-reform *status quo* here, with the observed regime of continuous deficit financing, are quite different from those that are present under the protectionist regulatory regime discussed in the previous section. The fiscal *status quo* cannot be modeled in terms of the classical prisoners' dilemma, where individuals' particular or operational interests may conflict with their more generalized constitutional interests. Any argument for constitutional reform must incorporate recognition of the distinct structural features. In the ongoing deficit regime persons living now, in their capacities as current recipients of publicly financed benefits or in their capacities as current taxpayers, secure net utility gains at the direct expense of persons who will occupy beneficiary-taxpayer roles in future periods (there will, of course, be some overlap between these groups). Deficit financing of current consumption is a pure intertemporal transfer. And, like all transfers, no efficiency gains are available that, even conceptually, would allow the potential gainers from a change (future-period taxpayer-beneficiaries) to compensate the potential losers (current-period taxpayer-beneficiaries). The argument for constitutional change must, therefore, be grounded differently from the interest-based logic of regulatory reform.

There are two separable features of the argument here, each of which is derived from a feature that is familiar in nonfiscal application. In the first, we ignore the collective decision aspects of fiscal choice and concentrate exclusively on the individual. Here any change in the rules that will restrict debt financing of current consumption must call upon some argument from the "economics of temptation." The individual who recognizes his own possible "weakness of will" in future periods may choose to impose upon himself binding constraints that will effectively prevent his situational responses as might be dictated by in-period utility maximization. This precommitment logic has been discussed by Elster, Schelling, Thaler and others in such examples as forebearance from tobacco, alcohol, food, and sex. Somewhat more generally, the argument may be extended to personally derived norms against pure consumption borrowing.

A second part of an argument for change in fiscal rules requires the introduction of the collective aspects of choice. Even in settings where an individual might not, upon reflection, choose to bind himself against consumption borrowing, he may well agree to bond or precommit the collective of which he is a member. He may do so because he does not "trust" his fellow members to refrain from "temptation," and because he

recognizes that in majoritarian settings, he cannot effectively forestall *undesired political* choices.[5] One or both of these elements may generate a consensus that a balanced budget rule should be adopted, despite the recognized current-period loss.

There is, however, an implication of the constitutional reform logic here that is not present in the regulatory example. Because rule changes here do, indeed, impose acknowledged current-period utility losses, relative to utility levels enjoyed in the absence of the change, consensus building may require that implementation be lagged over several periods. This time lag requirement is not central to reform in the regulatory constitution, as previously discussed.

Also, as the discussion suggests, the moral or ethical dimension of the comparative evaluation of the *status quo* and the alternative regime becomes important in the fiscal constitution whereas such dimension may remain relatively insignificant in the thrust for regulatory depoliticization. Deficit financing of current public consumption involves a more blatantly unjust transfer from future-period to current-period taxpayer-beneficiaries than the more diffuse transfer from consumers to producers in the regulatory setting. Quite apart from this difference in generality, there are also "excess burdens" produced by politicized interference with voluntary exchanges, the elimination of which offers a "cushion" for working out agreed-on compromises on rules changes. No such "excess burden" exists in the pure intertemporal transfers reflected in deficit financing. Only some introduction of a moral argument can oppose the play of self-interest here.

V. Potential Change in Monetary Rules

In the paper referred to earlier, Bernholz suggested that the dynamics of the inflationary process offer opportunities for implementing change in the monetary structure. In his analysis, nonconstrained discretionary authorities exhibit consistent inflationary bias due to the pervasive political pressures. As the authority responds by reducing the value of the monetary unit, the interests of government and of debtors, both existing and potential, are promoted at the expense of creditors. As potential creditors (lenders) recognize the inflationary patterns and make predictions concerning their continuance, they will demand and be able to secure protection of value through modified terms of intertemporal exchange. As this adjustment takes place, the earlier gains from inflation to the government on the one hand and to debtors on the other may be squeezed out, and, in some cases, converted into net losses. At some appropriate point in the dynamic sequence, there can be a genuine

[5] For elaboration of the argument here, see Chapter 21, in my *Liberty, Market and State* (New York: New York University Press, 1986), pp. 229-239.

convergence of debtor and creditor interests on a shift in structure toward a regime that embodies predictability in the value of the monetary unit.

Predictability, in and of itself, implies pure efficiency gains to all potential transactors who use money as a medium of exchange or store of value. There is an "excess burden" in nonpredictability that is analogous to that involved in politicized interferences with market exchanges, and this "excess burden" can provide a cushion for securing agreement among different interests. Note here that the efficiency-based argument for predictability is not the same as the argument for *stability* in the value of the standard, at least in any direct sense. On the other hand, if a change in regime insures predictability in the value of the monetary unit, there should arise no conflict among interests (*e.g.*, debtors and creditors) as to the direction or rate of change in this value through time. If all transactors make the same prediction as to the temporal path of change in the standard's value, and if the regime insures that these expectations are fulfilled, there is no difference in first-level efficiency between inflationary, stable, and deflationary patterns. Efficiency differences here, which may be minimal, arise only from differences in the resource costs of using money relative to other standards for storing value.

VI. The Welfare Politics of Constitutional Change

I have entitled this paper "prolegomena" for a strategy of constitutional revolution. My central point has been that we must understand the characteristic features in the diagnosis of regime failure in each of the three cases examined before proceeding to suggest specific reforms. This approach suggests, in turn, that the prospects for securing constitutional change need not be so dismal as pessimistic political economists sometimes seem to accept. With reference to both the regulatory and the monetary constitutions, there can arise some convergence of special interests in support of change; the thrust need not come from some effective representation of the generalized and diffuse interests of nonorganized and nonorganizable consumers. In regulatory reform, the very multiplicity of special interests who seek, and get, regulatory protection from the state may, at some point, insure that these interests, in their roles as consumers, will recognize the negative-sum aspects of the rent-seeking game in which they are all involved. In monetary reform, the dynamics of the inflationary sequence will possibly generate a convergence of interests on basic structural change at the appropriate point in the sequence.

In the fiscal constitution, the reform in the rules that will replace the regime of permanent deficit financing with one of balanced budgets is not so amenable to any convergence of interests as is the case with the

other constitutional sectors examined here. The overt conflict of interests here is not between groups within the existing population (between producers and consumers in the regulatory case, between debtors and creditors in the monetary case), but between "generations," or between temporally defined sets of taxpayers-beneficiaries. Some motivation other than the current interests of persons, whether organized in special interests or diffused and generalized, must describe any thrust toward the introduction of constitutional checks.

It may seem, in some respects, surprising that the agitation for constitutional change seems to be greatest precisely in this area where the interest-based thrust for change would seem weakest. On the other hand, the observed agitation seems to have produced relatively little effective change. Perhaps we can explain the differences in the three regimes, along with the prospects for dramatic constitutional change, by the characteristic features of the diagnosis after all. Because both the regulatory and the monetary rules are ultimately vulnerable to pressures from interest-driven coalitions in support of change, the excesses of departures from the dictates of efficiency-defined ideals may have been more limited. The protectionist intrusion of the modern state may be limited by the recognition that, if it extends beyond certain limits, it becomes self-destructive in the interest-driven polity. The monetary authorities, seeking always to protect their own bureaucratic interest, may reckon on the interest group feedback from too extensive an exercise of the inflationary engine. There is no such limitation internal to the fiscal profligacy that describes the financing of modern states; the relatively greater agitation for a change in fiscal rules arises precisely because there are less constraining internal checks.

STRATEGIES AND CONDITIONS FOR INTRODUCING A MONETARY CONSTITUTION

by
Dr. Peter Bernholz

1. Introduction

In a free society discretionary measures and interventions of government, bureaucracy and independent public agencies should be as limited as possible to

1. allow each individual as much freedom as is compatible with those of others;

2. to prevent the possible misuse of power by minorities and shifting majorities;

3. to promote justice and efficiency and to allow the formation of stable expectations by a reliable and stable legal system;

4. to allow the innovative and creative activity of many decentralized private agents relying on and motivated by stable property rights, enforcement of contracts and the rule of law.

A constitution limiting the rights and determining the duties of citizens, but also the discretionary powers of government is a precondition for the existence and maintenance of a free society (Hayek 1960; Buchanan 1974; Bernholz and Faber 1986).

All these problems have been widely discussed in the literature. Less attention has been addressed to the problem of how the wanted constitution of a free society can be reached in a situation in which wide discretionary powers of the government exist, or, in which outright oligarchies or dictatorship dominate. For can rules limiting the power and influence of government, bureaucracy and the interest groups influencing them be introduced, if the people benefiting from such a governmental system are opposed to constitutional reform? It is obvious that it is nearly as important to answer this question than the question what an adequate constitution of a free society should look like.

The question thus posed can only be answered if we understand the dynamics of change leading from one politico-economic system to another. What we need are theories explaining these relationships, theories which can only be found if we look carefully at the available empirical evidence. It is for this reason that I concentrate on the problems connected with the introduction of a monetary constitution. For work extending over years has provided some insights into the politico-economic dynamics underlying changes of monetary regimes, which might be helpful to address the questions stated above for a monetary constitution.

2. Characteristics of Discretionary Monetary Regimes

Monetary regimes leaving the decisions concerning the supply of fiat money to governments or to more or less dependent central banks are characterized by two rather negative traits. First if they are combined with flexible exchange rates they exhibit strong mid-term swings of real exchange rates, a fact which will be discussed below (Section 4). Second, they are biased in favor of inflationary developments.

Let us turn first to the second of these characteristics. If we look at the evidence for "relatively" stable currencies like the Swiss franc and the West German mark, we find that their values shrunk from 1950 to 1980 by 61.5 percent and 60.6 percent respectively (in terms of the cost of living index). If this was true for so-called stable currencies, we should not be surprised at the far greater depreciation recorded by other currencies. Indeed, a study of about 30 currencies shows that there has not been a single case of a currency freely manipulated by its government or central bank since 1700 which enjoyed price stability for at least 30 years running. This has been true even for "autonomous" central banks, although their currencies fared better than those manipulated by central banks more subservient to their governments.

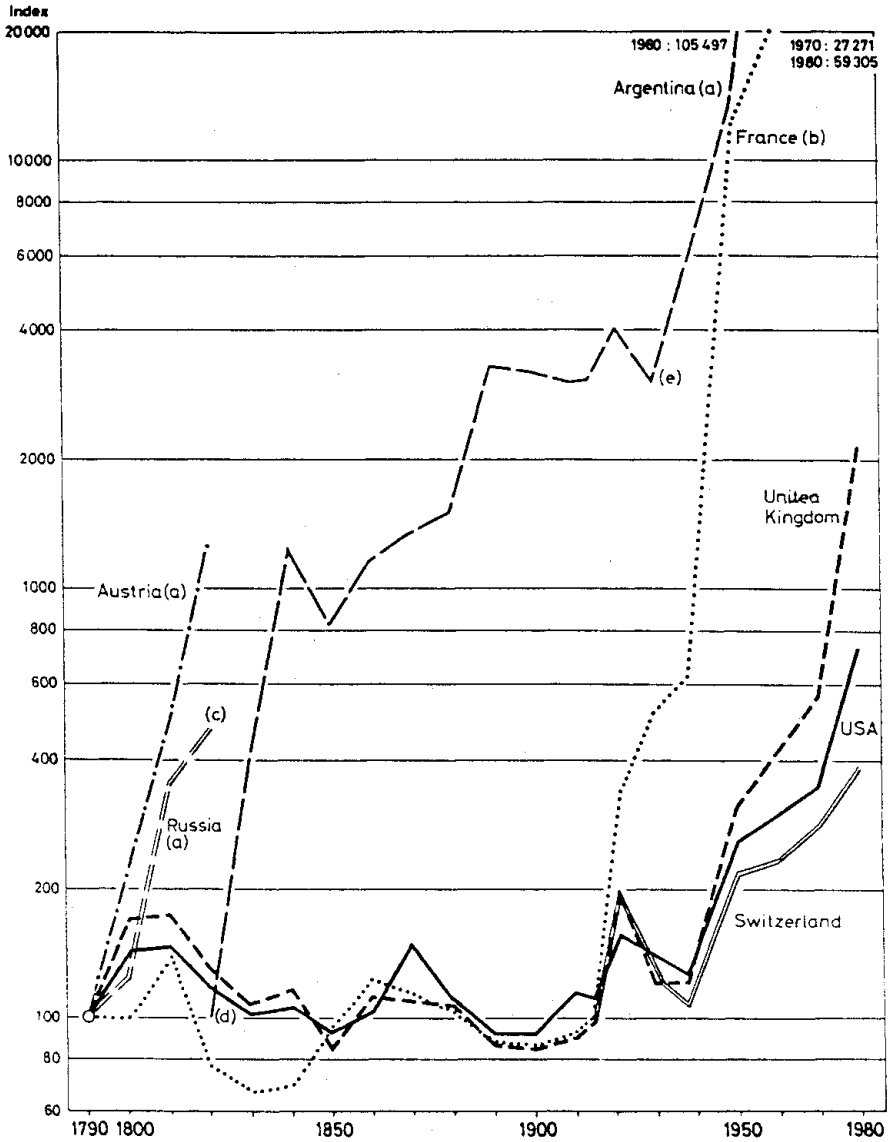
The picture would be quite different if governments and central banks were controlled by strict "monetary constitutions," like the gold or silver standards. Such systems allow public authorities hardly any discretion to control the money supply if banknotes and (indirectly) demand deposits have to be exchanged at the will of the holder, and at a fixed parity, into gold or silver.

Figure 1 illustrates this thesis clearly. The wholesale price index shows no trend between 1790 and 1914 for Great Britain, France or the USA. The same was true for Germany, Switzerland and other countries which were also on gold or silver standards. After 1914, or after 1931-36 (compare Table 1), when these countries went off the gold or gold exchange standard in favor of paper money standards freely manipulated by monetary authorities (fiat money), the situation changed dramatically. **Note that no hyperinflations are present in Figure 1.** The impression is reinforced if we look at the development of the value of fiat monies in the 19th century. Russia, Austria and Argentina were off the gold or silver standard for decades during that period (Table 1). The inflationary consequences are obvious.

In looking at the historical evidence, two points should not be forgotten. Gold and silver standards need not be the only inflation-free monetary regimes. There have, for instance, been proposals for other potentially inflation-free systems such as anchoring a monetary growth rule in the constitution (Friedman 1968) or having free competitive

Figure 1

Development of Wholesale Prices in Several Countries, 1790-1980



(a) Exchange rate on Amsterdam for Russia, on Hamburg for Austria, gold price until 1929 and exchange rate on U.S.$ since then in Argentina. (b) 1796=100. (c) 1814. (d) 1826=100. (e) 1929.

Source: Mitchell [1976, pp. 735-747]; U.S. Department of Commerce [1975, Part 1, pp. 199-202]; Bernholz [1982, p. 15]; Olarra Jiménez [1968, pp. 181-184].

private banking with no central bank monopoly (Hayek 1976; Campbell and Dougan 1986; Dorn and Schwartz 1987). All such systems, however, have hardly been tried, and it is not our purpose to discuss their relative merits *vis-`a-vis* each other or *vis-`a-vis* the gold or silver standards.

Second, not only the inflationary biases of monetary systems but also the variability of real factors such as real growth rates of gross national product and employment, real interest and real exchange rates should be taken into account when judging the merits of different monetary constitutions.

3. The Inflationary Bias of Governments and Central Banks

However, we are not concerned here with these problems and especially not with normative questions. Our intentions are the following: Given the inflationary bias of discretionary monetary systems, we first seek the political and economic causes of this bias. And second, we try to answer the question of what conditions make it possible to introduce an inflation-free monetary constitution in an environment favoring discretionary policies.

Table 1

PERIODS OF DISCRETIONARY MONETARY MANAGEMENT

Countries in Figure 1 were off the Gold or Silver Standards since 1790.

Country	*from*	*to*	*from*	*to*	*Comment*
Argentina	1824 1876	1867 1881	1885 1914 1930	1899 1927	
Austria	1797 1848	1819 1892	1914 1933	1923	
France	1789	1796	1914 1936	1928	Return to old parity in 1928
Russia	1786 1854	1839 1899	1914		
Switzerland	1914	1925	1936		Return to old parity in 1925
United Kingdom	1797	1821	1914 1931	1925	Return to old parity in 1821 and 1914
United States	1861	1873	1933		Return to old parity in 1873

Note: The above dates have to be taken with caution. Periods of legal and of de facto convertibility (used here) have sometimes differed. Austria had convertibility only of notes into gold in 1892; full convertibility followed in 1896. The United States kept gold convertibility for monetary authorities until 1971, and so on.

In testing our hypotheses we have to look at empirical historical evidence. In doing so we will find that only gold or silver standards have been introduced as inflation-free monetary constitutions. This does not imply that it would be impossible to introduce other inflation-free monetary constitutions under the same conditions. On the contrary, we think this would be feasible. It is simply not known whether and how well such alternatives would work, given the available historical evidence.

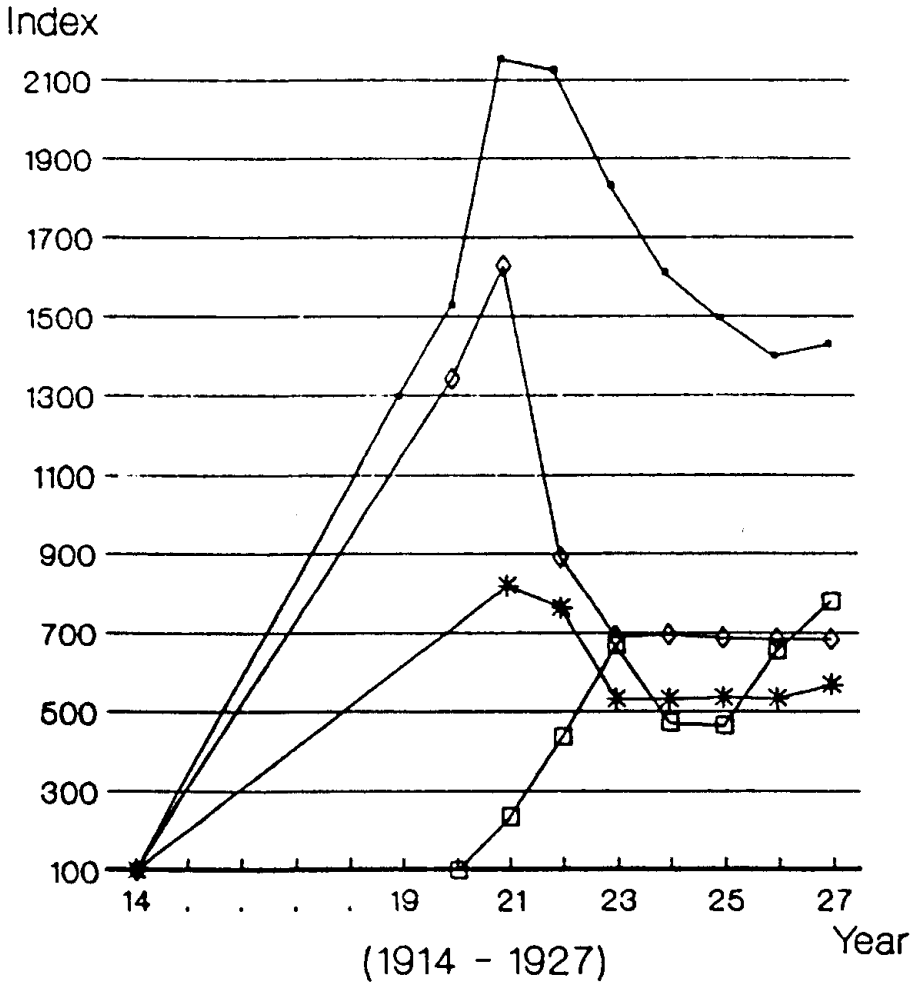
What are the reasons for the inflationary bias of governments and central banks? In trying to give an explanation it has to be remembered that politicians and their parties compete for the support of voters, of interest groups and of party members. Thus they have to provide benefits in the form of public goods, income transfers, subsidies and regulations without increasing the burden of taxes, as perceived by the population, too much.

Now, increasing the supply of money to finance such benefits is precisely such a method of taxation not easily discerned by the people, at least not in the beginning. Even later, the government or central bank will not be held responsible for the ensuing inflation by most citizens for a fairly long time. Moreover, by creating money, real interest rates are kept lower as long as inflation remains moderate and people do not anticipate the full consequences. In the first phase of the inflationary process, growth rates of real GNP and employment even increase. Inflation reduces the real government debt. Revenues from progressive taxes grow imperceptibly. It is obvious that in this phase the party (parties) in power will gain more votes than they stand to lose. Thus, there will be a definite preference for expansionary monetary policies. True, an autonomous central bank is less dependent on political support than the politicians. But central bankers need to be appointed and reappointed by the political authorities. They are usually obliged, by law, to cooperate with the government. And, last but not least, they, too, are influenced to a certain degree by interests expressed in their environment and enjoy wielding discretionary powers for the "public good."

The political pressures on politicians and central bankers change when the rate of inflation accelerates. Now price and tax increases brought about by inflationary financing will be seen as substantial by more and more voters. A rising number of people will perceive the devaluation of their nominal assets, expectations become inflationary and the positive influences of unanticipated inflation on unemployment vanish. Thus, more voters will vote against than for the incumbent party. The (new) government and central bank proceed to restrict the growth rate of the money supply to get inflation under control. But this policy change certainly does not mean that politicians persist in stabilization

Figure 2

Inflation and Stabilization in Czechoslovakia, 1914-1927



Source: Statistisches Reichsamt (1928 and 1921/22-1934).

—— Currency in circulation in Czechoslovakia and the USA, respectively.

—◇— Exchange rate for U.S.$.

—✱— Cost of living index for Czechoslovakia and the USA, respectively.

—□— Gold and foreign exchange reserves.

efforts until an inflation-free situation has been reached. Quite the contrary. Stabilization leads to a short-term increase in unemployment and real interest rates, as well as to further consequences to be discussed below. Thus, after a period of time, another about-face to more expansionary policies must be expected. The system shows a long-run inflationary bias.

4. Some Additional Features of Inflation Under Flexible Exchange Rates

We have already mentioned that strong medium-term swings of real exchange rates are characteristic for discretionary monetary regimes with flexible exchange rates. The reasons may be manifold. Especially under flexible exchange rates, monetary policies that are more expansive than those of other countries have such consequences which are also politically relevant. These consequences can be appreciated by looking at the example of Czechoslovakia in 1914-1927 (Figure 2). After the money supply in Czechoslovakia began expanding relatively more strongly than in the USA, the exchange rate of the dollar moved up more strongly and more rapidly from 1914 to 1921 than did the Czech cost of living index compared to that of the USA. Thus an undervaluation resulted which stimulated exports and discouraged imports, obviously to the advantage of the export sector and domestic industries competing against imports, and of their employees. Indirectly, the whole economy was stimulated, a fact which explains the political interest in expansionary monetary policies.

The situation changes when the relatively more expansionary policies are ended or (as in the case above) reversed. The exchange rate fell more rapidly than the relative price level (which, in other cases, can even increase further for some time) from 1921 to 1923. The undervaluation diminished and purchasing power parity would have been reestablished had these developments not been interrupted, as will be discussed later on. In other cases, an overvaluation may result for a time as a consequence of strict monetary policies and (or) strong deflationary expectations. It is clear that developments like these offset the advantages enjoyed by the export and import-competing industries and their employees. The advantages can even turn into disadvantages when overvaluation takes place. This, and the resulting unemployment, are additional factors working politically against a continuation of stabilization policies and in favor of another round of expansionary policies before inflation has been totally eliminated.

The case of Czechoslovakia, depicted in Figure 2, is not exceptional. In fact, about twenty historical cases from 1700 to the present have been studied in which the same qualitative pattern can be observed (Bernholz

1982; Bernholz, Gaertner and Heri 1985). Recently the U.S. dollar has followed a similar path against the West German mark and the Swiss franc. After the shift to flexible exchange rates in 1973, and with a relatively more expansionary monetary policy in the USA, the dollar devalued more strongly in terms of the mark or Swiss franc than corresponded to the movement of the relative cost of living indices. A sizable undervaluation developed. When the Federal Reserve Board turned to stabilizing inflation after 1979, the dollar recovered strongly. The undervaluation even gave way to an overvaluation of the American currency. From February 1985, U.S. monetary policy became much more expansionary again, which resulted in another strong decrease of the exchange rate of the dollar during the following three years.

5. How to Introduce a Sound "Monetary Constitution"

Given the inflationary bias of governments and central banks, it seems puzzling that sound monetary constitutions — like the gold and silver standards — could ever have been introduced and adhered to at all. The political interests outlined above will induce the authorities to oppose the installation of any sound monetary constitution, for such a system could not only severely limit the discretionary powers of government and/or central bank, but prevent them from reaping the short-term political benefits of expansionary monetary policies.

Given these facts, it must be asked what political and economic conditions allow, or even favor, the introduction of inflation-free monetary systems? At present we can describe two such situations. One occurs in the last phase of hyperinflation, in which scarcely anybody benefits from inflation anymore but nearly everybody is adversely affected by it. In such a situation, political advantages can be gained by introducing a stable monetary system through currency reform. Here we are interested in the second case, namely the introduction of a sound monetary constitution after moderate inflation has been experienced. In this case the solution to the political puzzle is forthcoming when the consequences of stabilization efforts are recalled.

It has just been argued that after the short-term economic and political advantages of moderate inflation have been exhausted, a disinflationary policy becomes politically feasible. Stabilization policies lead not only to rising real interest rates and unemployment and a slackening of economic activity in the short run, but also to a reduction and elimination of currency undervaluation or even to overvaluation. But this hurts the export and import-competing industries in particular and the workers employed by them. As a result, the political pressure to protect these industries against foreign competition will be stronger than that for reflating the economy.

True, consumers will be hit by protective measures, but the consequences are widely spread and are usually not perceived as the result of political actions. It doesn't pay for consumers to inform themselves, since only a small part of their budgets is at stake and the influence of individual voters on elections is so minute anyway.

Protection against foreign competition can take different forms: higher import duties or quantitative import restrictions, or an intervention against the home currency in foreign exchange markets to depress or stabilize its value. Again, the experience of the USA since 1985 gave good examples for the application of both types of measures and for the way protectionist pressure works in Congress.

A stabilization of the domestic currency can also be achieved by introducing a stable monetary constitution (like a gold standard with convertibility of banknotes into gold at a fixed parity for everybody). The political forces opposing a further revaluation of the domestic currency can be expected to support such a move, especially if the currency is still undervalued. This support will, moreover, be broader than that for protective tariffs or import quotas since the resulting stable exchange rate benefits not only import-competing but also export industries and is not as visible as the other measures favoring these industries at the cost of consumers.

Turning back to Czechoslovakia in the 1920's, this was exactly the policy followed. As can be seen from Figure 2, the currency was stabilized from 1923 *vis-`a-vis* the dollar at a still somewhat undervalued level. The political support was used to introduce the gold standard. The same qualitative patterns as those sketched out for Czechoslovakia can be observed in quite a number of countries after World War I (Table 2.1) and in Argentina in the 1890's. In all these cases, the currencies were fixed at new gold parities at undervalued levels. This led to balance of payments surpluses and a strong inflow of gold for at least a number of years. Because of the implied increase of the money supply, prices kept rising for a time, until balance of payments equilibrium was reached. There is further historical evidence that the introduction of the full gold standard in the Netherlands in 1875, and in Austria-Hungary and British India in the 1890's, was possible with the help of the same political forces (Bernholz 1986). It is thus not surprising that some politicians in the USA favored the reintroduction of the gold standard in 1984-85, when the dollar was already overvalued and rising to still higher levels.

Looking at Table 2.1, we observe that all the countries which re-established a gold (exchange) standard after World War I did so, with the only exception of Yugoslavia, at a more or less strongly undervalued parity. Moreover, all these countries experienced even more undervalued exchange rates in years preceding their *de jure* and (or) the *de facto*

stabilizations. This supports our hypothesis that the fixing of exchange rates was a response to diminishing undervaluations. Note that Yugoslavia and Czechoslovakia have been taken as successor states of Serbia and of Austria-Hungary, respectively, in Table 2.

It is also instructive to compare the experience of the countries of Table 2.1 with those which returned to their prewar gold parities after World War I (Table 2.2). I have argued elsewhere (Bernholz 1986) that in these cases the return to prewar parities was helped by being perceived as a return to normal peace-time conditions after the war. Moreover, that the reestablishment of the old parity could only be accomplished because the internal price level compared to that of the USA had not increased too much. For only in this case could the opposing political forces of export and import-competing industries and of those employed by them, be overcome. In fact, CPI/CPI* is, for all countries in Table 2.2, much lower than for those of Table 2.1, with the only exception of Peru. Also, five out of seven of the countries returning to prewar parities, stabilized at about purchasing power parity, quite in contrast to those in Table 2.1. But even for the countries returning to the prewar parity we find that, except in the case of Sweden, all these currencies had been undervalued before.

6. Advanced Inflation and the Budget Deficit

It is well-known that advanced inflations and hyperinflations have only occurred when a substantial budget deficit has been financed by creating money (Jaksch 1985). If the budget deficit and (or) the already outstanding debt of the government is so big that foreigners or the domestic public are no longer prepared to buy enough interest-bearing assets from the government to cover the deficit, then inflationary financing is unavoidable. This shows that a budget always has to be financed by the present generation, *i.e.*, the present generation has to forego the resources claimed by the government. If this cannot be accomplished by ordinary taxes and by voluntary lending, it is done with what has to be called the inflation tax.

Can an inflation tax be maintained indefinitely? This is an interesting theoretical and empirical question. Theoretical articles have been written in the spirit of optional taxation theory on the optimal rate of inflation. I doubt, from a public choice and a purely economic perspective, whether such an optimal rate of inflation could ever exist in reality. But it is true that inflationary processes with varying rates of inflation can be observed since decades, especially in some Latin American countries. Still, from the empirical evidence, it appears that this is only possible if the real budget deficits and the rates of inflation are cut down from time to time (Paldam 1985).

Table 2

DEGREE OF UNDER(OVER)VALUATION OF SEVERAL CURRENCIES IN THE YEAR OF THE FORMAL (RE)ESTABLISHMENT OF THE GOLD (EXCHANGE) STANDARD AFTER WORLD WAR I

(1914 = 100)

Undervaluation(Overvaluation): CPI/(CPI* × ER) >100 (<100)

Country	*Year of (Re)Establishment*[1]	*CPI*	*CPI**	*ER*	*CPI/ (CPI* × ER)*	*Minimum CPI/ (CPI* × ER)*[6]
1. Countries without hyperinflation and not returning to the prewar parity						
Italy	1928[2]	572	170	360	73	42 (1920)
Portugal	1931	1990	151	2319	57	48 (1923)
Romania	1929	4244	167	3270	78	35 (1922)
Bulgaria	1929[3] (1924)[5]	3662 (2561)	167 (169)	2411 (2400)	91 (63)	49 (1921)
Greece	1928 (1927)	1868 (1790)	168 (170)	1476 (1462)	75	62 (1923/26)
Finland	1926 (1924)	1183 (1170)	174 (169)	766 (767)	89 (90)	70 (1921)
Peru	(1928)[4]	174	170	112	91	85 (1921)
Chile	1926[5]	198	178	161	69	56 (1921)
France	1928 (1927)[5]	519 (514)	168 (170)	490 (492)	63 (61)	49 (1926)
Czechoslovakia	1925 (1923)	951 (918)	178 (173)	687 (691)	78 (77)	50 (1921)
Yugoslavia	1931 (1926)[5]	111[7] (1804)	107[7] (152)	1090 (1131)	95 (105)	74 (1923)
Belgium	1927[5]	817	169	694	70	62 (1926)
2. Countries returning to prewar parity						
Great Britain	1925	169	174	101	96	83 (1920)
Netherlands	1925[5]	154	174	100	89	75 (1920)
Sweden	1924 (1923)[5]	174 (177)	170 (170)	101 (101)	101 (103)	101 (1924)
Switzerland	1925	168	174	100	97	90 (1920/23)
Norway	1925	177	170	100	104	73 (1924)
Denmark	1927	176	173	100	102	76 (1920)
Argentina	1927	132	173	100	76	65 (1923)

Symbols:

CPI Cost of living index of respective country.

CPI* U.S. cost of living index.

ER Exchange rate of U.S. dollar in terms of respective currency.

Footnotes:

[1] De facto return year in brackets.

[2] The gold parity of the lira was fixed on December 21, 1927. Thus it seems to be adequate to take the figures for 1928.

[3] The gold parity of the Lev was fixed on December 3, 1928. Thus the figures for 1929 have been taken.

[4] Only a de facto stabilization took place.

[5] Since the gold parity was (re)established at the end of the preceding year, figures for the following year have been taken.

[6] Maximal postwar value of CPI/(CPI* × ER) before de jure (or de facto) stabilization.

[7] Wholesale price indices.

Sources:

For U.S. cost of living index: U.S. Department of Commerce, Bureau of the Census (1976).

Statistisches Reichsamt (1928).

Statistisches Reichsamt (1936 and 1937).

For dates: Schwarzer and Schneider (1988).

For one case, at least, we get a clear-cut result. If the budget deficit as a proportion of government debt remains greater than the growth rate of Gross National Product for a sufficiently long time, it cannot be financed by issuing debt and (or) the inflation tax. Given this tautological fact, it is important to note that once inflation accelerates enough, this always increases the real budget deficit. For expenditures have to be paid rather soon, whereas tax revenues come in with more or less extended lags. Thus it can easily happen that the real budget deficit cannot be maintained once it has, at least partly, to be financed with the inflation tax and if the rate of inflation has crossed a certain threshold. The tendency towards higher real budget deficits is strengthened by the fact that the real demand for money decreases with the rate of inflation. This means that the base of the inflation tax shrinks so that the government has to increase the tax rate, namely the rate of inflation, by issuing more money to obtain the same real revenue from the inflation tax.

What happens in such circumstances? For a long time economists have thought that the real stock of the inflating money decreases to lower and lower levels (which is true), that the velocity of circulation rises and that more and more people return in more and more transactions to barter (which is only true to a rather limited extent).

Recently, however, it has become more and more obvious from the empirical evidence, that currency substitution takes place, *i.e.*, that good money drives out bad money in spite of all governmental regulations trying to prevent this. The lower real demand for the inflating money is compensated for by a rising real demand for good money (Bernholz 1988). It follows that under conditions of advanced or hyperinflation, the government has either strongly to cut back inflation or even to erase it with a monetary reform. Otherwise the increasing rate of inflation would not only lower real revenues from ordinary taxes but also from the inflation tax to insignificant amounts. Since the "good money" is nowadays foreign exchange or indexed domestic money, and has often been in former times gold and silver coins, the government would also lose its control of the money supply.

If the government is politically unable to undertake the necessary reforms or if the reforms falter, it can happen, and has happened that the bad national money is driven out totally by the good money (Table 3). Then the government has finally to legalize the good money to receive tax revenues again. The budget problem has to be solved, since no inflation tax is available any longer. These problems are clearly seen by Holtfrerich (1980, p. 310), when he states concerning the German hyperinflation "that the stabilization of the currency was rather necessary in Germany because of a crisis of the state rather than of the economy. The economy had widely changed to a foreign currency standard, with which

Table 3

ADVANCED INFLATIONS ENDING IN TOTAL NATURAL SUBSTITUTION OF BAD THROUGH GOOD MONEY

Country	*Period*	*Earlier Currency Reform Failed*[1]	*Kind of Good Money*	*Source*
United States	1776-81	March 1780: new dollar bills 1 :20	specie and state paper money	Phillips 1972, p. 170 sq. Bezanson 1951, pp. 325 sq.
France	1789-97	February 1796: mandats territoriaux 1 : 30	gold and silver specie	Thiers 1840
Peru	1875-87	September 1880:[2] incas 1 : 8	silver coins	Garland 1908, pp. 58 sq.
Mexico	1913-17	June 1916: infalsifiable currency 10 : 1	gold and silver specie	Banyai 1976, pp. 73 sq. Kemmerer 1940, pp. 114-15

[1] By a currency reform, we understand a change of the monetary regime with the **intention** to produce a new stable money. The mere removal of zeros or introduction of newly denominated paper notes is not considered to be a currency reform.

[2] From the report given by Garland it is doubtful whether a currency reform was seriously intended.

it could have lived.... The crisis originated since the Reich could and would not tolerate the use of foreign currency for domestic transactions wanted by the economy because of reasons of national self-preservation and especially as long as the inflation was needed as a source of revenues" (my translation).

We conclude that advanced and hyperinflations have their own dynamics which finally enforce reforms. These reforms have to solve the problem of the budget deficit and of money creation at the same time. Whether this crisis of the state and the necessary reforms lead to an inflation-free monetary constitution depends on the ideas available at this juncture in history.

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Comment by Dr. Buchanan

Dr. Buchanan: First of all, I would like to say in response to what Professor Bernholz has said — and those of you who are economists will appreciate what is involved here — what I tried to say in my response to his Cato paper, which is an earlier version of what he has given to you. I want to stress that what you have heard is quite innovative.

Nobody else, to my knowledge, has really tried to get at this whole problem of what I call the strategy for constitutional change. Professor Bernholz has really been going all over the world getting all these historical experiences, and trying to identify and isolate to the extent possible what are the situations from which we can expect prospects for genuine monetary constitutional shifts. It is a very innovative research program. It is a very long-term research program. I was telling him the other day that eventually he is going to have a treatise of at least a thousand pages when he gets through with all this. I should just emphasize to those of you who are not familiar with this, that this is way out-front type research that he has just reported on.

Now, I thought I would try to bring this to the end, before we get into the question period, in part by giving you some problems that we face in trying to get this convergence of interests, to get some genuine reform in a monetary constitution. I said I would come back to this. I said I would come back to the interests of the bureaucrats themselves. And I want to tell you a personal story.

People often ask me what I have to do with the Reagan administration. Do I advise the Reagan administration? Do I consult with the Reagan administration? Or have I done so? And so forth and so on.

My answer is that I have had nothing whatsoever to do with the Reagan administration, with the exception of the fact that some of my students have been important in the Reagan administration. Jim Miller, the budget director, is, of course, a student of mine, as are other people in the Government. But as far as direct influence or consulting or anything like that to this administration, I have not been involved at all, with one exception. And the exception bears directly on what we are talking about today.

Immediately after the election in 1980, Martin Anderson, who was on Reagan's campaign staff, wrote around to several of us soliciting suggestions as to what the new president coming in 1981 could do in the first 100 days of his administration to give an indication that this was going to be an administration with a policy thrust: things that would not require Congressional action that would give an idea of an administration that was going forward. Well, I thought about that a little and I wrote a letter back to Anderson suggesting that what the president could

do when he came in was to appoint a presidential commission that would look into the whole structure of our monetary authority, the whole structure of the Federal Reserve authority, the monetary authority, the central bank authority of the United States. And it seemed to me high time that might be looked into.

We have had a very, very peculiar monetary regime in the United States, a peculiar monetary constitution. You see, our Federal Reserve Board was set up in 1913, legislatively, in response to pressures to have some central agency that would, in fact, be able to facilitate the offsetting of regional credit crises. That is, to facilitate the transfer of funds around when you have problems in Texas or somewhere else like that. But this was all under the umbrella of an international gold standard. And then, of course, in the 1930's we got off the gold standard in the sense that individuals no longer had convertibility. We still stayed on a gold standard of sorts for international convertibility up until 1970, and then we got off the gold standard totally. Over that period of a half century, we totally demonetized gold. So we got to a situation where the dollar has absolutely no basis in any commodity base, no convertibility.

What we have now is a monetary authority that essentially has a monopoly on the issue of fiat money, with no guidelines to amount to anything; an authority that never would have been legislatively approved, that never would have been constitutionally approved, on any kind of rational calculus, no matter what the political system. We have an authority that just happened to get there and happened to be in place when we demonetized gold totally and completely over this half century. So I thought it was a good idea to use that presidential commission-type device to get a little publicity, to get a discussion going about the legitimacy of this authority.

Well, I sent that in in early December and then over the Christmas holidays that year, the interim between the time Reagan was elected and when he went into office, I got a call from the so-called Kitchen Cabinet of President Reagan, the people around him who were meeting in Los Angeles, saying that they were very interested in this proposition and would I do a little more on it, would I be willing to be chairman of this commission if it were set up, and who should be on it, and so on and so on. Well, I remember spending several days over that Christmas holiday working very hard calling around to people whom I thought would be important members: some from banking, some from other industries, some from the academies who might be interested in this. Secondly, I wrote a short position paper — something the President could in fact use to announce such a commission — and shipped it off by one of these courier expresses out to the Western White House where Reagan was preparing his administration.

Nothing happened. Absolutely nothing happened. I never heard a word, not one word, from them. I found out months later, that they did seriously consider the idea, but Arthur Burns shot it down. Arthur Burns totally and completely rejected it, and would not have anything to do with any proposal that would challenge the authority of the central banking structure — you don't even question, you don't even raise it as an issue to be discussed. Arthur Burns had been the Chairman of the Federal Reserve Board, had taken upon himself the bureaucratic cloak, and had taken it as his mission to defend the institution as it is, independently of any question. It became a sacrosanct institution to Arthur Burns, and he prevailed in the Reagan councils.

I later found out that Milton Friedman also had suggested another type of proposal for this same purpose; that the new president would announce that from hence forward, he would at least look at quasi-officially the reports of a Shadow Open-Market Committee. In the United States, there has been for a long time a so-called Shadow Open-Market Committee, operated by Allan Meltzer and Karl Brunner, which essentially monitors the behavior of the Federal Reserve Board and issues reports. Friedman's proposal was that the president give quasi-official status to this by saying: "I'm going to read their reports." That was also killed by Arthur Burns, totally and completely.

One of the major difficulties that I think all of us face in trying to get a dialogue going — after all, we need to get some dialogue going before we can get anywhere in this monetary constitutional change — is we have got to get over the barrier of bureaucratic interest in maintaining what is, and that is an extremely strong interest.

It is difficult for me to understand how anyone could intellectually defend what we have. That is, the one criterion, it seems to me, that is central to any effective monetary constitution is predictability in the value of the monetary unit. I challenge anybody to sit down and draw up a regime that could be less predictable than we have now! Nobody could dream up a worse situation than we have now.

In the United States monetary structure, you have a committee with no guidelines, with a total monopoly on the issue of fiat money. How could you possibly predict? But everyone of us who uses money has to predict, because we are going to invest. We are going to put our money here or there, start up a new business, or whatever. So we could not conceivably have a worse regime, and I don't see how anybody can defend it. That is the reason I was shocked; intellectually, I thought the battle had long since been won.

I was in Pittsburgh 4 weeks ago, and I will tell you another pertinent story. At breakfast, I happened to sit next to Norman Robertson. He was the chief economist at the Mellon Bank in Pittsburgh, a very well-trained

economist. I made roughly the same comments to him that I just made to you about the current regime. He really got on his high horse, really was objecting to what I was saying, and he was trying to defend discretionary power. He did not want any limits on the discretionary authority of the central bank, at least our own central bank. So, he was in a sense in league with the Arthur Burnses.

The bureaucracy has with it not only its own members, not just the people who have served on the Board and their staffs; it also has a strong representation in the business community itself. I guess Robertson's position was fundamentally that somehow he could make more money for Mellon Bank if he knows roughly what those discretionary authorities will do, as opposed to persons that he doesn't know. So in a way the banking structure feeds on this. I don't think we ought to underestimate the difficulties of getting away from the status quo, because you have these power centers that are entrenched. Its going to be very difficult.

But on the other hand, I don't want to end on a pessimistic note. Allan Meltzer, whom Professor Bernholz and I met at a discussion in Interlaken the other day, when we told him we were coming down here to talk on this topic, said to us don't get their hopes up too much. Don't think our hopes should be up too much, but on the other hand, it's too easy to be pessimistic about the possibility of getting a genuine shift in regimes. If we try to make some straightforward predictions, maybe everyone would be pessimistic. But as I have already suggested here, and as Professor Bernholz's work indicates, if we look back 20 years, and if we look at what has happened in terms of the dialogue in the academies, people are now actively discussing this topic. Twenty years ago, nobody was discussing this topic.

I have always felt that first of all we have to get a dialogue going. We have got to get some people concerned about the basic fundamental rules of the game, the constitutional structure. And the fact that the Nobel Prize committee, for example, awarded this prize to me and in part in the citation stated quite explicitly that it was because of my work bringing back some of the discussion of constitutional structures about economies and how the economies depend on this constitutional structure. That recognition itself is an encouraging sign. If we look at it from the point of view of how the dialogue has changed, without getting ourselves too hopeful, without expecting miracles, but seizing on these opportunities, I think there are favorable prospects within limits. Some of my friends accuse me of being too optimistic, but I think personally I have — and that those who work in this field have — a moral obligation to think that we can improve things. I will leave you with that, and welcome your questions.

Conference Addenda by Professor Buchanan to "Prolegomena for a Strategy of Constitutional Revolution"

International Attitudes toward Constitutional Regimes

I think that those of you who are American or know the American scene will have a much more natural feel for this [subject of constitutional change], because I think there is a distinction here to be made between what I think of as the European attitude and the American attitude. I think Americans naturally think more in constitutional terms. That is, constitutions are designed to limit governments, whereas that is much less of a natural attitude for those of you who grew up in a parliamentary democracy or culture of parliamentary democracy. I have written on this at length and those of you who know my work know that I will be repeating or summarizing material that I have gone over many times.

Consensual Agreement for Change

The players, or participants, not only need to agree that they do not like the rules that exist. They also have to agree on an alternative. I think the monetary regime here is a very good example. A former colleague and I wrote a piece a few years ago which we called "Monopoly and Money and Inflation," in which we concentrated on this particular problem. That is, a lot of discussion about the monetary constitution involves economists and others agreeing that what we have is not desirable. But they debate about the alternative. And as long as they cannot agree on an alternative, they end up retaining the status quo, which is the worst of all possible situations, at least in my view.

The Regulatory Constitution

By the regulatory constitution, I am referring to the proclivity of governments, and modern governments in particular, to intervene, interfere, prohibit, constrain, and regulate voluntary exchanges among individuals and groups, both domestically and against foreign competition. It embraces a whole thrust of measures under the protectionist label, both internal and external: control over wages, rents, prices, interest rates, entry into and exit from industries, occupations, locations, licensing, zoning — all of that comes under the regulatory umbrella, plus protectionist policies against imports and so forth and so on.

Obviously, you can easily see how particular producer interests are separately motivated to try to get differential protection for their own groups. But the characteristic feature that I think offers hope in that area for genuine constitutional reform is in fact that if that tendency becomes generalized enough, and if we get enough of these interferences, which certainly does describe the modern economy, then we all are losing. This

happens even though a particular interest may be gaining. We end up doing much worse than we would be able to do if we could simply wipe them out and sweep them away.

The Fiscal Constitution

By the fiscal constitution, I mean the attempts to modify our structure of our decision-making such that we require politicians to balance the budget. I have been a long-time advocate in the United States of a proposed constitutional amendment to require budget balance. Because without budget balance, at least since Keynesian economics, we see the natual proclivity of politicians is simply to spend without taxing. And, if we allow them to spend without taxing and do not impose any constraints on their so doing, the easiest of all predictions from a public choice perspective is, of course, that they will create permanent deficits and deficit regimes.

It is very difficult to get constitutional change in that respect, because that is not like the regulatory constitution, in which everybody is being damaged. Rather, what is happening in the fiscal dilemma that we face is that, by acting out these natural proclivities in creating deficits, what the politicians are able to do is to provide current-period benefits to their constituents at the expense of taxpayers who are not around yet. It is an inter-temporal transfer.

It is much more difficult to get a convergence of interests on doing anything about that, because we are essentially stealing from future generations of taxpayers. I have suggested and argued at length that we are really involved in a moral problem here. The moral dimension of the continuation of this deficit regime is, of course, what I have concentrated on in some of my discussion.

Conference Addenda by Professor Bernholz to "Strategies and Conditions for Introducing a Monetary Constitution"

The Pertinence of the Topic

Now, the question concerning a monetary constitution actually has two sub-questions. The first is, what kind of a monetary regime should we have? This is a big question, and it has been hotly discussed over the last decade. When I looked back at the historical material, I realized that there always had been waves where monetary constitutions and regimes had been hotly discussed. This has usually been the case in times when there was a lot of dissatisfaction with the monetary constitution. However, the second question to be asked is: if we have agreed on some kind of monetary regime, how could we get there? I think the second question

is at least as important as the first one. Otherwise, one could easily point out — and politicians quite rightly have often done so to their economic advisers — you are telling us we should do this and that and that is maybe quite good. But how can we do it politically?

Now, I would go even further. I would say that there are forces in the political process to which I will come in a moment, which are working against the introduction of a sound monetary constitution. So, I will concentrate on the second question. Of course, the whole paper reflects implicitly on the question of the kind of monetary regime that is desirable.

You may ask yourselves: why should we discuss monetary constitutions at all, especially here in Switzerland? Is it that big of a problem? We have relatively stable currency here. The same is fortunately true in many other European countries. They are dominated by the German mark system, and they are following a policy similar to that of the Swiss National Bank. This is certainly true.

But let me mention first that, in a absolute sense, the record is not quite as good as we may believe. Namely, over the past 30 years the mark and the Swiss franc have lost about two-thirds of their value. This is not a very good record compared to the gold standard, as I will show.

Second, there are many countries where the record is much worse. Even around Europe — look at Italy, Ireland, France, and others (we have to acknowledge that in Britain the policies have become better) — the situation looks worse. Not to speak of countries in Latin America.

Moreover, perhaps even for industrialized countries with relatively stable exchange rates, like Switzerland and West Germany, we have to acknowledge that the disorder of the international monetary system has led to very big swings in real exchange rates as we now are experiencing again. This is also a reflection of the monetary regime, and it is hitting even the relatively stable countries. They can't prevent being hit because these exchange rates are disturbed not only by their own policies, but also by the policies of other countries. So, you can't escape the international monetary system even if you have a relatively good policy.

I would stress that I think that the Swiss National Bank and the German Bundesbank have done a good job within the setting of the present constitution. I would like to underline that, especially since my remarks might be understood critically. But I am now discussing the problem on another level. I am discussing the constitutional level. I am not concerned with the question of how efficiently the monetary authorities have worked with a given set of rules, but, as Professor Buchanan has pointed out, I am concerned with the system of rules itself. Could there not be a better system of rules, and could one reach that system?

Effects of Abandoning the Gold Standard

You can see what happened [see Figure 1 in the Bernholz paper]: wholesale prices or exchange rates went up. Now, this looks really dramatic, and, of course, this depends on the time dimensions. These are decades. But it is dramatic. It would seem to show some relation between the monetary regime and the performance of the system so far as inflation is concerned.

The test of this is to look at the few countries that went off the gold or silver standards, which we had until 1914 or the thirties, and went toward a discretionary standard. I have them here in the 19th century. Here we have Austria; here we have Russia; and here we have Argentina. You see they were on discretionary regimes. Clearly, you had the same picture in the 19th century that we have later on for the European countries. There seem, however, to be a few periods of stabilization. It is interesting that Argentina tried to return to the gold standard. So, it is quite obvious that we have these inflationary tendencies in the current discretionary system, but we did not have them with the gold or silver standards.

Next, I should perhaps mention that this is true even for nations with independent central banks, like West Germany and Switzerland. On the other hand, central banks are not unimportant. We can show that the rates of inflation are lower in these countries than in the other countries where the Finance Ministers control the money supply. So, the money supply seems to have something to do with politics.

I should stress that monetary stability is not the only criterion by which we should judge a monetary regime or constitution. For instance, the fluctuations of real magnitudes like employment, real growth rates, gross national product, real interest rates, and real exchange rates are also important. There is some evidence that real growth rates of gross national product and real interest rates fluctuated somewhat more under the gold standard than they did from 1950 to 1980. Of course, 1950 to 1980 may not be the right period, because we had the postwar boom going on then. On the other hand, real exchange rates move much more strongly, and this has certain consequences. So much about the performance of the system.

Inflating away Government Debt

As I mentioned, inflation reduces the real government debt and permits revenues from progressive taxes to grow imperceptibly. In this respect, I mention that this is an important factor for the United States, since it is the only country that can express its foreign debts in its own currency. It can inflate away even that real debt. This may be another problem for discussion.

I still recall a discussion with the former president of the Swiss National Bank, Fritz Leutwieler, on the money growth rates to select for the next year as a target. He said, "well, let's put one more percent on it because of political reasons." This gives you an idea.

Flexible Exchange Rates

The smaller the country, the more relevant they are. Therefore, benign neglect is a possible policy for the United States, but certainly not for Switzerland and possibly not for West Germany or France. I have used the example of Czechoslovakia from 1914 to 1927. Of course, I could take a more recent example: namely, the swings of the real exchange rate of the dollar. But you all know them. So, I take an earlier example to show that these swings have always been the case. Actually, I studied about thirty cases beginning with 1700. They all have the same qualitative characteristics.

With reference to Figure 2, in Czechoslovakia, which was at that time part of Austria-Hungary, the money supply relative to that in the United States increased strongly (the upper line). As a consequence, you had two developments: the relative rate of inflation went up (the cost of living index compared to that of the United States); but the exchange rate with the U.S. dollar went up more strongly and more rapidly. This is always true if you have a more expansionary monetary policy. The exchange rate moves up more strongly and this means an undervaluation of your currency in real terms. Recall that we (the Swiss) had the same after our system moved to flexible exchange rates *vis-`a-vis* the U.S. dollar. The U.S. monetary policy from 1973 on was more expansionary than the Swiss (and the German float by the way, too), so we got an overvaluation of the Swiss franc, which means an undervaluation of the mark or the U.S. dollar. So, the same happened here.

I should add a few words about what it means politically that we have such developments. It means the following: the protection given to the export industries and import-competing industries, and, of course, to the people employed by them, vanishes. You defeat the imported inflation, but at the same time you have a bad effect on employment and on the situation of export industries and import-competing industries. You get more and more political resistance against it. We know it very well in Switzerland. Industry begins to complain, quite rightly. If you are in such an industry, you have to care for your industry. That's quite obvious. You are responsible. So, we have a general tendency here: when we have strong fluctuations of real exchange rates, the politicians or central banks respond to them because of the political pressure implied by these exchange rates.

What are the responses? Perhaps I should say a few words about that.

It is interesting to look again at the United States in 1985. What responses did we get? Well, the political forces asked mainly for more protection. This is still going on. The move toward protection was very much reinforced in 1984 and 1985. The second is, the monetary authorities are asked to intervene against their own currency and to have a more expansionary monetary policy. And third, there may be some people asking for a change in the monetary regime. All of this happened in the United States, and it happened in other cases, too. We know when the Swiss franc was overvalued in 1978, many people asked for interventions and changes in monetary policies, and finally the Swiss National Bank did this. Within a few months, it increased the central bank money by about 30 to 40 percent in 1978-79. Together with the change of U.S. policies, this had the consequence of turning the process around.

The Timing of Changes in Monetary Regimes

We know now how a monetary constitution can be introduced after moderate inflation. It is interesting to note that the discussion about introducing another monetary constitution is usually taken up in such times of disturbance. Even in the United States in 1985, you had some people who asked "let's at least return to the Bretton Woods system, or to some kind of managed fixed exchange rate." There were even some people proposing to return to the gold standard. And there was a gold committee of Congress. Why did they introduce that just at that moment? This is very revealing, I would say. I have a lot of discussions in the countries which returned to a stable monetary system. So in a sense you use the forces of those people wanting to have some expansionary policies, inflationary policies, at that juncture and harness them for long-term, stable development caused by the monetary constitution that was introduced.

Let me add a few words concerning hyperinflation. If you are in a hyperinflation or advanced inflation like in Latin American countries or many European countries in the 1920's — Poland, Germany, Austria, Hungary are examples — then in a sense you have no choice. If you are in an advanced inflation, the probability is very great, if you cannot get rid of the real budget deficit, that you will end up in hyperinflation. And this means that people are demanding less and less money in real terms (money divided by the price level), because everybody who holds money is taxed by the inflation and loses by holding money. Thus, the inflating money is used substantially in hyperinflation. I have just studied Bolivian hyperinflation. The real money stock went down to about 20 percent. In the German hyperinflation it was worse; it went down to about 6 percent of the real money stock.

What does this mean? It means that the basis for the inflation tax

shrinks. But, if the basis of a tax shrinks, and you want to have a tax revenue, then you have to increase the rate. The "tax" rate here is the rate of inflation. So, the rate of inflation has to increase and it increases more and more rapidly. Well, in the end (I have put together a few historical cases where I am quite sure about the developments) the government tried currency reforms that moved into another monetary constitution, but faltered. What happened then? Foreign exchange replaces the defunct currency. But when foreign exchange comes in, then you lose your monetary sovereignty. Modern nations don't want that very much. So they try currency reform — or have to try it. And usually they try it at the last minute.

In Germany, for instance, this was the main reason. In 1923, more than two-thirds of the money supply already consisted of stable money, most of it foreign exchange circulating in Germany. The government wanted to preserve its monetary independence. So in a sense, with hyperinflation, or advanced inflation, which has to turn into a hyperinflation, it's obvious that you must have a reform. If you don't have reform, the market takes account of what is happening and solves the problem anyhow.

As a result of currency substitutions I described above, there has to be a currency reform if the government wants to maintain its money. But the currency reform implies a budgetary reform. Under these circumstances, you can only have a currency reform if you get rid of the real budget deficit, which you cannot finance by issuing ordinary interest-bearing debt. After an advanced inflation, who is prepared to buy the ordinary interest-bearing debt? So the government really has to solve the problem of the budget deficit. But since nobody believes them, they are absolutely discredited by the advanced inflation. As a Brazilian told me in Brazil, if the government says something, we believe the opposite. They have two institutional reforms. That is, they have to introduce a new fiscal constitution at the same time that they introduce a new monetary constitution. That is the only way to solve the problem. The government has to be bound so that it cannot incur more debts (have a budget deficit) and not create more money. So, in a sense, this is the situation with inflation, and I submit that even a moderate inflation has something to do with the budget deficit.

Dr. Gilmour: Thank you very much. I note that both of you have commented that nobody was doing this type of research 20 years ago, that no one was looking into this. I will have to send you both all of our publications, many of which consider the issues we have discussed here tonight.

I was delighted when I read your papers for the first time this afternoon, because much of what you talk about and many of your interests are very similar to those of E. C. Harwood, founder of AIER. Indeed, at one point about 15 or 20 years ago, he tried to embark on the question of how constitutional change might best be promoted in a way that would involve not only creating a more stable monetary regime, but also resolving fiscal problems, and so on. His own recommendation was to embody in the constitution itself a requirement that any currency be convertible into monetary metals as one method.

Well, I have a couple of questions from the audience: Doctor Buchanan or Doctor Bernholz, do you agree that a devalued currency leads to a favorable trade balance in the long run? Or that a stable currency leads to an unfavorable trade balance — West Germany and Switzerland may be examples?

Dr. Bernholz: As I have suggested in my paper, it certainly has an influence whether you have an undervalued or overvalued currency, and this brings about just the political forces I have described. But the question is perhaps pointing to a deeper level: namely, could we have, for instance, a stable monetary constitution, let's say in Germany or Switzerland, without having this damage? My answer is quite clear to that. It would be impossible for a small country, and even a medium sized country, to introduce on its own a really stable currency like the gold standard. The arguments I presented and the empirical evidence I gave you suggests you would get an overvaluation such as happened to Germany and Switzerland because of their more stable monetary policies. Recall that then they had to give them up.

So, it is quite clear that the same thing would happen to an even more stable monetary policy implied by a constitution which prevented the inflationary creation of money, whatever it is. I am not only speaking about the gold standard. In this sense, I think the question is very warranted indeed and it leads us to the conclusion at the moment that, from an international point of view, probably only the United States or the European community could take such a step. We have to be modest, you see, and no small country can do that.

Dr. Gilmour: A second question from the audience is directly related to that: If nothing can be worse or nothing is worse than the present

monetary regime, what is wrong with getting back to a gold standard?

Dr. Buchanan: First of all, I would like to correct what I had said in response to Dr. Gilmour's observation. I am very glad that he did raise that point about Mr. Harwood and your Institute. When I said that very few people were discussing programs of constitutional change within a monetary context I was referring primarily to academic economists. All of us are provincial in our own limits, and I live and work in the academy. I was essentially talking about people in the academy of university research, and that has been the change. I am very glad you mentioned that because the Institute and also a few other groups have been working on this for a long time. Some of us in the academy are now catching up — and that is a worthwhile addition to the discussion. I am glad you brought that up.

Someone asked me outside what Professor Bernholz and I were going to debate on today. I said we weren't going to debate on much. We had had this discussion in the Cato conference and that actually was kind of a complementary discussion and we did not disagree on very much. I suspect that we might disagree a little on the gold standard. I suspect he might be a little more pro-gold standard than I would be.

The question has to do with why not just go back to the gold standard if the current regime is just about as bad as it could be? I tried to stress in what I said that a lot of us might agree to diagnose what it is that is bad that we need to change, but we might disagree on what the alternative is. And then that just leaves us accepting what is the status quo and that is a very great danger. We ought to try to agree on an alternative, and that is true that that is the only way we are going to get this thing moving forward.

Certainly a gold standard of almost any variety in which we had convertibility may be of almost any variety. (Only partly in jest, I might say that I happen to favor a common brick standard, for example. Charles O. Hardy, a famous monetary economist earlier in this century in the United States advocated a common brick standard for the simple reason that you can make common bricks in any county in the United States. Its about the only commodity you can do that with. And its easy to convert into and out of common bricks and you can define what it is in terms of a quality standard pretty well.)

As you know, an objection to the gold standard made by people who do not necessarily advocate the gold standard is that you are dependent on the supply of gold or inelastic possibilities. Then you might have discoveries that can affect your money system, money value. On the other hand, the gold standard advocates have going for them historically a very important mystique of gold. Gold is the only thing that has a kind

of mystique, and one important feature or characteristic of an effective money is a kind of credibility notion.

Somehow or other, people have to have trust in money. A friend of mine, the British economist Herbert Frankel, wrote a fascinating book on this sort of money and trust, which is very important, and gold is about all that can provide that [See S. Herbert Frankel, *Money and Liberty*, Washington, D. C., American Enterprise Institute, 1980–ed.]. The problem with the gold standard, of course, historically was that you did not have a gold standard. I suspect that a lot of us who want to have monetary regime changes would agree that one of the best possible systems might be a genuine gold coin standard. But we don't trust states to allow that to happen and we don't trust banking structures to allow that to happen. You'd get into a gold reserve standard. And when you get into a gold reserve standard, you get all of this vulnerablity to switching into and out of the base money again.

I am not necessarily anti-gold standard. I think gold would be far better than what we have. But I think there might be better regimes. I think if I had to choose an option, I would be in favor of Irving Fisher's old scheme. That is a legislative mandate to the Federal Reserve authority to stabilize the value of the dollar in terms of a price index, which is of course stabilizing it not in terms of one commodity, but in terms of all commodities that go in the index, by the weights that they go in the index.

Interestingly, we came within an inch of having that in the United States. In the middle of the Great Depression in 1934 as you remember (those of you who remember the history, or have read the history), almost anything could happen in '34. Most of what happened was bad. But a lot of things could happen. Wright Patman was a young Congressman, and he got through the House Irving Fisher's scheme. According to that bill, the Federal Reserve Board would have been directed to stabilize the value of the dollar in terms of a price index — the wholesale price index. That went through the House.

Carter Glass, an important Senator at that time, killed it in the Senate. But it did pass the House in 1934. If I had to choose an option, I think I would start that way. But I certainly would rank gold or some kind of a gold standard much, much, higher than what we have. So that is my position. But I suspect on that Peter and I might differ.

Dr. Bernholz: I do differ, and that is a problem with the present discussion about monetary regimes. While many of the leading economists would now subscribe to some change of the present system, they are at odds about what regime to put in its place.

Well, let me first also respond to your remark, Dr. Gilmour. I have myself done a study, for instance, on the ideas about the monetary

regime of the German liberals — or the liberals as they called themselves — and they had already done important work even under the Nazi regime, when they prepared the liberal regime which the Federal Republic accepted later on. That they did this under the Nazi regime is very interesting in itself. Many, of course, were related to the resistance movement and you can judge from that.

We had there fundamentally the same discussion, beginning in the 1930's and going into the 1950's. Of course, this was going on in small circles, which had relationships to the Americans and others — [Frank D.] Graham and other names you can think of. Its obvious they had some followers in the United States, but it never surfaced really. That is the important thing.

Under the Bretton Woods system, it looked as though you had somehow sufficiently solved the international money problem. Not very many people saw in the late 1950's or beginning 1960's that the system had to break down because of the discretionary regime behind it. You simply cannot have a fixed exchange rate system which is long term, with a long term duration, without abolishing the discretionary regimes. I should like to stress that.

It is not a question of just returning to a fixed exchange rate system. This wouldn't solve the problem. Many people now — with the recent experiences of flexible exchange rates — just forget the experience with fixed exchange rates under the Bretton Woods standard. That is another mistake, and I would like to warn you.

This brings me back to the question that we have to answer at the moment. I am very much more pessimistic than Professor Buchanan about having Fisher's proposal to stabilize currency values according to a price index. This is interesting, Jim, because you excel in constitutional thinking. Can you put such a rule into the Constitution? What are the weights? Are you going to put the weights of the different commodities in the index into the Constitution? If not, the central bank can manipulate them. And the Government can manipulate even the basket of commodities you put in. Do you put that in the Constitution, too? And who is monitoring the system? I see great difficulties there.

Of course, other regimes also have difficulties. You mentioned for the gold standard that the supply of gold might be subject to new discoveries. This is a difficulty. When they had the California gold rush, or when the Spanish went to Latin America, and shipped all that silver and gold over to Europe, it was then that the quantity theory of money first developed, the first coherent theory of inflation.

But I have looked at the historical record. The rate of inflation implied from, say, 1550 to 1600 was never more on the average than 2 percent per year. We would be glad if we had that now. And the same is true for

the California gold rush, and also for the gold findings at the end of the last century in Alaska. Why is this so? Well, because the new findings, even if they are big, are only a very small percentage of the stock you already have. Therefore you have an automatic stabilization. Moreover, if the new findings change the price level, then obviously the cost to produce the gold increases compared to the price of gold, which is fixed, and therefore production decreases. So you have some automatic stabilizer.

But there are other difficulties. I mentioned, for instance, that small to medium sized countries cannot go to the gold standard on their own. A second difficulty I mentioned is that it may be that we have stronger real fluctuations of some variables under a gold standard. So I am not quite sure about the problem. We have to do more research.

I have a thesis currently in progress in Basle on the Swiss monetary system which was, of course, a gold-silver standard before the Swiss National Bank was founded in 1907. And it is very interesting that the Swiss electorate at least twice rejected the introduction of a central bank. So it seems to me that they can't have been too dissatisfied with the system. And it gives interesting insights. We need many more empirical studies. We have a very good one by Larry White about the Scottish system, which seemed to have worked very well [Lawrence H. White, *Free Banking in Britain*, New York, Cambridge University Press, 1984].

There are many different gold standards. That has to be stressed. I would never be in favor of a gold-exchange standard. It has so many failures. I think that its failure when it was reintroduced as a gold-exchange standard in the 1920's had a lot to do with this fact that we didn't have a pure gold standard with circulating coins and the central banks keeping gold reserves, not foreign exchange, and things like that. I can't go into that very much really, but it is important.

Even if we could introduce a gold standard, then I would be for a much changed gold standard. For instance, one idea I have thought a lot about is the following: The duty to convert money into gold at a fixed parity and vice versa has been limited to monetary authorities under the old gold standard. This is a very limited right. What I would propose is that every creditor has the right to demand from his debtor if he wants, payment in gold of the debt at a fixed parity. This is quite a different system, and it has one big advantage. In this system, you could have innovations — namely, in the banking system, with the monetary authorities, and so on. I think it is all-important that we have the possiblity of innovations. Of course, nobody knows what the best monetary regime is. We have to experiment to find it. And therefore we need the possibility of innovation.

It is the same as developing new goods. In a firm, you need the

possibility to try new things, to make experiments. But all experiments are now prohibited by this monopoly structure stressed by Dr. Buchanan. We have a rigid system which has no innovations. Well, we have innovations. But the innovations are in the financial market and for the purpose of trying to circumvent just these regulations. And this may lead to instability in the system too. Therefore I think it's dangerous, and we should try to get innovation back to the core of the system. We shouldn't make it too rigid, and I would propose a much more general rule.

One last comment. It is rather lengthy, but it is perhaps an important question. I do not believe that the monetary regime can be fixed in another way than binding it somehow to a commodity standard. Why is this so? You have two possibilities principally. You can either fix the price of money, that is, a commodity standard with fixed parity — gold, silver, or a basket of commodities, even the brick standard (which may be something like that, though I doubt some other aspects of it). The other possibility is to fix the supply of money, the stock of money, or its growth rate. That is the present position of some central banks, at least in a limited way.

I do not think this can be maintained in the long run because of the many innovations we have in the financial sector and the monetary sector. What does it mean if I have here a credit card of American Express or whatever? What does it mean if there are overnight interest-bearing assets which can, each minute, second, be changed into money? Are all these financial assets money? What is money? What is the delineation of money? I have the feeling that especially in the United States, where we had most of these innovations most rapidly, the Federal Reserve System is running behind the innovations just to keep control of the system.

If nobody knows what the stock is, how can you prevent it from going in the wrong direction? So, in the long run, I don't see another possibility than to have some kind of commodity standard.

Dr. Gilmour: Thank you. If I may be permitted to exercise my moderator's prerogative, one thing struck me in both of your presentations and in your papers. That is, in terms of the fundamental methodology that both papers employ, it seems to me there are a number of assumptions involved with respect to the authority that derives from constitutional structures. It would seem to me that much of the argument depends on the assumption that a rule of law is indeed accepted in society. This is a general matter, and perhaps beneath even constitutional structures or certainly most monetary economic theory.

I think many observers in the United States today would probably argue that respect for law and, if you will, the mystical quality of law, is at a low ebb, at least in comparison with many other times. I began my

academic career as a Civil War-Reconstruction historian, and I can't help reflecting on the fact that the Old South was singularly representative of a "strict constitutionalist" regime if there ever was one. On the other hand, the actual behavior of participants in that society diverged enormously from the so-called rules. There were subsets and subsets and subsets of behaviors that were applied.

So, my question with respect to the present discussion is: in a society where law — be it statutory law, constitutional law, or whatever — is eroding, can we expect that even quite dramatic changes in institutional structures will have much effect on behavior? Obviously, the implication is that they may not have, as the development of alternative ways of getting around the rules proceeds. If they are not perceived by people as being the right rules this tends to happen. I think the same observation would apply if I were to go into a formal critique of your method: that observing a few series here and there, up and down swings, we might conclude one thing; but we might, in fact, look at other series that suggest that the very times that you identify as being propititious for changes in fundamental constitutional arrangements may in fact not be so; for example, when disrespect for law is widespread and disagreement as to appropriate remedial measures so great.

There are, in other words, a great number of factors involved. I think probably that if there were a methodological divergence between the approach that both of you have used tonight and what AIER attempts to do in its research, it might best be described as the difference between an interactional-institutional approach which sees individuals dealing with one another within this system of constraints and what we have called in the past a "transactional" approach, which encompasses as much, as many factors, as possible. Now obviously we don't get very far with what we say because we try, perhaps, some say to do too much at one time. There are, I think, constraints on anyone's research dealing with a specific topic.

But I welcome your views, and I think what you've said will be welcomed in print by all of our readers. This the first time that anyone I know in academia has actually been dealing directly with these specific problems and looking at historical episodes in order to find relationships that are meaningful in terms of predicting or at least estimating what the prospects for specific changes might be. You might wish to respond briefly to that rather long discourse.

Dr. Buchanan: Well, I support the point you make about the rule of law, the erosion of what I like to call constitutional wisdom or constitutional knowledge, which I think the American people, certainly its founders, had, in the 18th century. I think the fact that we lost that, and have lost it, has come home to haunt us. And I certainly share the view,

as some people put it, that constitutional change is not going to — that people get the kind of constitution they want in a sense. Unless you have a widespread attitude of respect for basic rules and fundamentally a distinction is made between changing the rules and acting within the rules, you are not going to get constitutional reform. Certainly our current legal interpretations, our legal philosophy now taught in our law schools, and so forth, reflect a fundamental misunderstanding of what the Constitution is all about. And it is pessimistic if you look at that.

But I think constitutions can constrain governments and I think the shift in the dialogue, and I come back to that, is the hopeful sign. But I certainly would not in any form or fashion want to paint a rosy picture of what the attitudes are. If anything, the erosion is still continuing. I just like to hope that there is a direction of change. As I say, sometimes it takes a long time to turn the Queen Mary around, and maybe the rudder has been shifted already. That is all I would even suggest.

Dr. Berhnolz: Since Dr. Buchanan made general remarks, I would like to turn to the monetary aspects of the question you ask. I think it is a very fundamental question and it is very basic and actually it is very important for our whole approach. That is quite obvious. I am grateful that you asked this question.

Actually I have, in looking at so many historical examples, necessarily had to think about this. First, let me take up the Swiss case because it is a very good example there. We are formally legally still on the gold standard in Switzerland. Factually we ended it in 1936 with emergency measures by the government. And, if we believe the government, we are still in a monetary emergency. Otherwise we would follow the constitution. So, in a sense, you could say we are always breaking the constitution. It is the same as with the Federal income tax. For 30 years, we were breaking the constitution to compensate the tax scale for inflation, you see. That is very bad. Now we have some institutional background here which might also be necessary to reform — to have a system which really works.

First of all, we can change the Swiss constitution by simple majorities in popular initiatives. That is one thing. Then, we don't have a constitutional court, a court which is allowed at all to judge whether the government follows the prescriptions of the constitution. In such a case, you would not expect it to work very well. Then we have very broad emergency powers of the government. That is also very dangerous, as Weimar Germany especially experienced. Because of the emergency clauses, Hitler could grasp power formally in quite a legal way you see. We have something similar concerning the monetary constitution.

So we have to see this whole system, and if we speak about constitution, it has to be interrelated in such a way that such things are

not possible. This means, of course, restricting the powers of the government. This means to have the rule of law, as you pointed out.

Even then there may be a judicial court, like the Supreme Court in the United States, itself eroding the Constitution by reinterpreting it as they want. This is now very fashionable in the United States I understand. Now that is the danger, and I have thought about this.

What can one do under such circumstances? Well, the possibility I mentioned just before to you about the more general gold standard is exactly connected to this problem. Namely, you have to remove the monetary system, or the basis of the monetary system, far out of the reach of the government, so far that it is even out of the thinking of the government and politicians. And this is certainly not true if you have a central bank, especially one directed by a finance minister. An independent central bank is the first step toward taking it out of the political process.

My proposal aims at taking it out much more. The state would just fix, let's say, the parity similarly as it fixes measures and weights. You would be much more secure with such a system. The other thing is that if you anchor it internationally, that is, if it is broadened to many nations, then one nation has a hard time changing it. For instance, it is quite interesting to look at the story of the last century. Even Latin American countries repeatedly tried very hard to go back to the standards set by the industrialized countries. It didn't prevent them from again and again diverting from it, but it kept their inflation rates much lower than nowadays, and again and again they tried to revert to it. So an example was set. Moreover, if an industrialized country like Switzerland had left the gold standard, with all the others remaining on it, this would have had dire economic consequences. Thus, there was a sanction built into the system to keep the monetary constitution.

At the heart of the discussion of Dr. Buchanan, for instance, you should also have a legal constitutional rule limiting budget deficits. If you have that, then the possibilities of breaking the monetary system, or even fostering the interest to break it, are much more limited. Any successful monetary system has to be an interrelated system, and we have to take all this into account. I know it is a difficult question and we will never have the full answer. It is like squaring the circle in a sense. But I think we can do a lot.

Dr. Buchanan: Let me just say one thing. I just had an idea and I wanted to ask you. As you know, one of the problems that we had was that the Supreme Court in the 1930's outlawed the gold contracts. We had certain contracts that were denominated in gold and the court said that they no longer were valid. Now I am trying to think of a stepping stone toward your more general thing. What if we should just pass

legislation, or a constitutional provision, that said gold contracts were legal again? That's all. Suppose we did nothing else. Then it is obvious that you would start having a lot of contracts made in gold. It wouldn't start out universally as you say, and you wouldn't start it out with monetary convertibility. But as people feared inflation, you'd get more and more contracts being written. These would be legal contracts, constitutionally protected. Then it would spread very rapidly, I would think.

Dr. Bernholz: I would just say that I personally would recommend such a clause, but even more general: namely, that people are absolutely free to fix the units in which they want to express their contracts. This is an important point. For instance, in the Federal Republic of Germany there is an article in the Bundesbank law which explicitly prohibits people from using other units of account than the Deutsche mark, even indexing a contract in any way without explicit permission of the Bundesbank itself. There you have this monopoly power again. If you limit some of these monopoly powers, like the budget and debt, then even the interest in breaking the monetary constitution vanishes by itself.

Dr. Gilmour: Thank you very much. I see that our time has run out. Dr. Studer has some concluding remarks.

Dr. Studer: Ladies and gentlemen, I am sure you agree with me that we have heard some most fascinating views and opinions on tonight's subject, "Prospects for a Monetary Constitution." Again, very many thanks to Professor Buchanan and Professor Bernholz for having accepted our invitation to speak. I am also very grateful to Dr. Gilmour and Dr. Handy from the American Institute for Economic Research for having so successfully organized our conference. Ladies and gentlemen, I hope to see you in 2 years at our next monetary conference.

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